

Staff Request for Permission to Proceed with Proposed Amendments to California Code of Regulations, Title 18, Section 25137, Subsection (b)(1) – Use of Property of Another to Extract Natural Resources; Conforming Amendments to California Code of Regulations, Title 18, Section 25130

Pursuant to Franchise Tax Board Resolution 98-7, Staff requests approval to release draft amendments to an existing regulation providing exceptions to the property factor, with these amendments specifically addressing how rent shall be determined for interests in timber, oil, gas and hard minerals located on the property of someone other than the taxpayer. The draft amendments would codify current administrative practice, as set forth in Legal Ruling 97-2, with certain modifications.

In accordance with the memorandum of the Chief Counsel dated January 15, 1999, entitled "Processing Regulations," Staff requests approval to follow the partial symposium process and announce a potential symposium date of December 11, 2002.

Regulations adopted to implement UDITPA provide for an adjustment of the standard apportionment formula under certain circumstances. The discussion draft amendments provide for treating royalty and other payments made for timber, oil, gas and hard mineral interests located on the property of someone other than the taxpayer as rent for property factor purposes. The draft amendments reflect the Franchise Tax Board's current administrative practice, as set forth in Legal Ruling 97-2, that such payments constitute fair rental values and provide appropriate property factor representation for the assets at issue.

Copies of the Discussion Draft Amendments to California Code of Regulations, Title 18, Sections 25137, Subsection (b)(1) & Section 25130(b)(4)-(5); Explanation of the Discussion Draft; and proposed FTB Notice 2002-(Draft) are attached.

October 1, 2002



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FTB NOTICE –2002-(Draft)

**SUBJECT: REQUEST FOR PUBLIC COMMENT
DISCUSSION DRAFT: AMENDMENTS TO CALIFORNIA CODE OF
REGULATIONS, TITLE 18, SECTION 25137(b); CONFORMING
AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS, TITLE
18, SECTION 25130**

The Franchise Tax Board staff has prepared a discussion draft of proposed amendments to the existing regulations adopted under Revenue and Taxation Code section 25137. The proposed amendments would add provisions designed to address how to calculate the net annual rental rate of a taxpayer for property factor purposes for the use of property of someone other than the taxpayer on which natural resources such as timber, oil, gas or hard minerals are extracted.

Due to the potentially broad impact of this addition, the Franchise Tax Board staff is making the draft of the proposed amendments and a brief explanation thereof available to the public for informal review and comment prior to formal regulatory notice.

For copies of the discussion draft of the proposed addition to the regulation or for further information regarding this notice, contact Colleen Berwick at the Franchise Tax Board Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Tel.: (916) 845-3306; Fax: (916) 845-3648; E-Mail: Colleen.Berwick@ftb.ca.gov. The draft and explanation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.

Written comments may also be addressed to Ms. Berwick and should be submitted no later than November 25, 2002. If significant public interest is voiced and/or written comments are received, the department will hold a public meeting or symposium on these proposed amendments prior to commencement of the formal regulatory hearing process. If the discussion draft amendments are officially noticed, any comments received in the course of any symposium or public meeting will be included in the official rulemaking file (within the meaning of the Administrative Procedure Act). Participants may comment at the symposium without name attribution. A summary of the symposium will be made available to all participants, and will also be included in the official rulemaking file.

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The department has tentatively scheduled a symposium to discuss the discussion draft amendments on December 11, 2002, at the Franchise Tax Board, Central Office, 9645 Butterfield Way, Sacramento, CA, in Room 1040 of Phase II, beginning at 10:00 am. **If no public interest is voiced and no written comments are received by November 25, 2002, the symposium will be canceled. Notice of cancellation will be published on the Franchise Tax Board's website no later than December 3, 2002.** If you have any questions regarding the symposium, please contact Ms. Berwick.

If you are interested in obtaining supplements to the draft proposed amendments, or to be included on the mailing list for any formal rulemaking activity with respect to the proposed amendments, please advise Ms. Berwick at the above address and she will add your name to the mailing list.

The principal author of this notice is William Hays Weissman of the Franchise Tax Board, Legal Branch. For further information regarding this notice, contact Mr. Weissman at the Franchise Tax Board, Legal Branch, P. O. Box 1720, Rancho Cordova, CA 95741-1720; Tel.: (916) 845-5708; Fax: (916) 843-5433; E-Mail: William.Weissman@ftb.ca.gov.

Explanation of the Discussion Draft, 18 Cal. Code of Reg. Section 25137(c)(1)(A). Special Rules. Property Factor.

Attached is a discussion draft of a proposed addition to the regulation addressing special rules for the property factor of the apportionment formula.

The addition to the regulation will apply to taxpayers who use property owned by third parties to extract natural resources such as timber, oil, gas or hard minerals, but who pay no rent or a nominal rent for use of that property. The proposed addition calculates the net annual rental rate to be included in the property factor by including only those payments required to be made and actually made by the taxpayer to the holder of interest in the property, to be capitalized by eight.

The draft reflects the Franchise Tax Board's current practice, as set forth in Legal Ruling 97-2, that such payments constitute fair rental values and provide appropriate property factor representation for the assets at issue. The regulation is also intended to end the uncertainty that currently exists because of difference between the analysis and conclusions in *Appeal of Procter & Gamble*, 89-SBE-0028, September 25, 1989, and the withdrawn May 4, 2000, decision in *Appeal of Kimberly-Clark Corporation*, regarding how the net annual rental rate should be calculated for natural resources. It also clarifies that improvements taxpayers might be required to make, such as improving mill facilities, are separately included in the property factor at cost as the taxpayer's property, regardless of whether the taxpayer is allowed to remove such fixtures at some future time.

Section 25130 is amended as follows:

(a) ...

(b) ...

(4) "Annual Rent" does not include: incidental day-to-day expenses such as hotel or motel accommodations, daily rental or automobiles, etc.

~~(A) ...~~

~~(B) Royalties based on extraction of natural resources, whether represented by delivery or purchase. For this purpose, a royalty includes any consideration, conveyed or credited to a holder of an interest in property which constitutes a sharing of current or future production of natural resources from such property, irrespective of the method of payment or how such consideration may be characterized, whether as a royalty, advance royalty, rental or otherwise.~~

(5) Leasehold improvements shall, for the purposes of the property factor, be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor. (See reference in Section 25137(b)(1)(C).)

Section 25137 is amended as follows:

§25137. Other Apportionment Methods.

(a) ...

(b) Special Rules. Property Factor.

(1) The following special rules are established in respect to the property factor of the apportionment formula:

(A) ...

(B) Except as provided for in Section (b)(1)(C), if ~~IF~~ property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a reasonable market rental rate for such property, a rental rate that would be negotiated at arm's length between a willing lessee and willing lessor, whether neither party is related or under duress, in an open and competitive marketplace for similar properties for the taxable year at issue. For purposes of the preceding sentence, "nominal rate" shall mean a token payment that is without any reasonable connection to a rental rate that would be negotiated at arm's length between a willing lessee and willing lessor, whether neither party is related or under duress, in an open and competitive marketplace for similar properties for the taxable year at issue.

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- (C) If a taxpayer enters upon property owned by others for the purposes of extracting natural resources such as timber, oil, gas or hard minerals, irrespective of whether such entry or extraction is pursuant to a lease, contract or other agreement between the holder of the interest in the property and the taxpayer (and also irrespective of whether such relationship is characterized as a *profit à prendre* or some other relationship), consideration actually paid by the taxpayer to the holder of the interest in the property that constitutes a sharing of current or future production or extraction of the timber, oil, gas or hard minerals from such property (irrespective of the method of payment or how such consideration is characterized, whether as a royalty, advance royalty, rental or otherwise) and consideration actually paid by the taxpayer for the right to enter the property and extract the timber, oil, gas or hard minerals (such as forest management fees, fire protection fees, reforestation or reclamation fees, road maintenance fees, etc.) for the taxable year at issue shall constitute the net annual rental rate. Improvements shall not be included in the calculation of a net annual rental rate, but shall be separately accounted for under California Code of Regulations, title 18, section 25130, sub. (b)(5). The net annual rental rate shall then be multiplied by eight (8) in accordance with Revenue and Taxation Code section 25130.
- (D) If a taxpayer makes a one-time lump sum payment under Section 25137(b)(1)(C), such payment will not be considered nominal, and will be governed by the standard apportionment rules under section 25130.

Example (A): On December 31, 2000, a taxpayer engaged in the paper products business enters into a 50-year forest management agreement with a government entity to commence January 1, 2001, that allows it to harvest 100,000 cords of timber per year from forests owned by that government entity. In exchange for the right to enter the government's land and harvest timber, the taxpayer agrees to pay a royalty fee of \$10.00 per cord extracted, plus a \$10,000 per year access fee, \$10,000 fire protection fee for any fires caused by the taxpayer, and a reforestation fee of 10 percent of the royalty fee paid. The forest management agreement also requires the taxpayer to make \$1 million worth of improvements to an existing mill facility owned by the government entity. In taxable year 2001, the taxpayer harvests 50,000 cords and does not cause any fires to occur. It also makes the \$1 million in improvements to the existing mill facility. The taxpayer therefore pays the government entity the \$10,000 access fee, \$500,000 in royalty fees (\$10.00 per cord times 50,000 cords), and an additional \$50,000 for the reforestation fee (10 percent of the \$500,000 royalty fee). The taxpayer is entitled to claim \$560,000 as the net annual rental rate. The taxpayer includes \$4,480,000 (\$560,000 multiplied by 8) in the property factor for this property for taxable year 2001. In addition, the taxpayer includes the \$1 million in improvements in the property factor as property owned by the taxpayer in accordance with Section 25130(b)(5) for taxable year 2001.